

September 30, 2004

**HONORABLE MAYOR AND CITY COUNCIL:**

In accordance with Section 701(F) of the San José City Charter, I hereby transmit to you a report describing the financial status of the City as of the end of the 2003-2004 fiscal year. As specified in the City Charter, the primary focus of the City Manager's Annual Report is a comparison of actual revenue collections and expenditures to projections included in the City's budget.

The Annual Report document is organized into three sections: (1) Letter of Transmittal, (2) General Fund performance, and (3) Special/Capital Fund performance. The Report also includes a number of recommended actions revising both the 2004-2005 Adopted Operating and Capital budgets. These actions also generally fall into three categories: (1) rebudgeting prior year funds for projects not completed last year; (2) reconciling budgeted Beginning Fund Balance amounts in various funds, including the General Fund, with the actual results; and (3) recommended actions necessary to revise the 2004-2005 budget to reflect more up to date information.

This Letter of Transmittal is intended to provide the Council with summary information regarding the contents of the Report. Included is an overview of the 2003-2004 General Fund financial performance; an analysis of the potential impact of that performance on the current year budget; a discussion of the financial status of selected other City funds; and descriptions of recommendations for revisions to the 2004-2005 Adopted Budget in a number of funds, including the General Fund.

**RECOMMENDATION**

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It is recommended that the City Council:

- Accept the City Manager's Annual Report produced in compliance with City Charter Section 701 (F).
- Approve Appropriation Ordinance and Funding Sources Resolution amendments in various funds as detailed in Section III ("Appropriation/Clean-Up Adjustment Actions"), of this report.
- Approve position addition and deletion actions in the Planning, Building, and Code Enforcement and Parks, Recreation and Neighborhood Services Departments also described in Section III of this document.

## OVERVIEW

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On an overall basis, our review of 2003-2004 year-end fiscal results confirms that, in spite of suffering the impacts of a local economy which is, and remains in, the midst of one of the most severe economic downturns in decades, the City of San José remains in a strong financial condition. Despite the fact that we have faced significant fiscal challenges for three consecutive fiscal years, we can be very proud of the fact that we have survived these difficulties without suffering the type of severe impacts seen in some other local governments around the State and country. We have avoided having to lay off City employees, and our core services remain intact, although often at a reduced level. We also ended another tough year in the black, and can report for the General Fund a small surplus over the budgeted ending fund balance estimate.

This is not to say that the actions necessary to remain fiscally sound have come without a cost. While we may have been able to place all impacted employees in alternate positions through aggressive maintenance of a hiring freeze now entering a fourth year, crucial City positions have been lost, and important City services have been severely impacted. It is a fact that a number of services available to the citizens of this City as recently as four years ago have now been curtailed or eliminated. It is a credit to the City Council's commitment to conservative fiscal policies that have guided this City through good times and bad, that despite one of the worst economic downturns in the last several decades, we have made the tough decisions necessary to remain fiscally sound and well regarded by those agencies whose job it is to rate City financial conditions.

A review of the outcomes outlined in this report does make clear that the 2003-2004 fiscal year was shaped for a third straight year, by the continuing economic woes of the Valley. The positive news was that the local economy showed signs that the precipitous downward slide of the prior two years had slowed. We do appear to have bottomed out. The bad news, however, is that there are no tangible signs that a significant improvement in the City's fiscal situation is anywhere near. In fact, all signs point to a continuation, for at least the entirety of the 2004-2005 year, and likely beyond that, of the current stagnant revenue situation. Thus, the City needs to prepare for the likelihood that the next several budgets will require continued fiscal restraint, and the probability of more painful fiscal actions.

There was some relatively positive news, at least in comparison with the dismal performance of the prior two years, in the latter half of 2003-2004. The long string of monthly reports of job losses were replaced with a couple of months where there were jobs added, albeit in very small numbers. In addition, the string of quarterly sales tax reports that were below the same quarter in the prior year ended at ten, when we actually experienced two quarters that had very small growth. (Some caution is urged, however, in this area, as analysis of the Sales Tax receipts by our outside consultant indicates that a majority of the increase in Sales Tax receipts was related to one-time adjustments that may not translate into future receipts.) In fact, in 2003-2004, for the first time in two years, General Fund revenues actually grew very slightly, by \$5.3 million or 0.8% from the prior year.

## **OVERVIEW (CONT'D.)**

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This basically flat performance when compared to the prior year was the result of a mix of increases and decreases in various revenue categories. Other early indicators of economic recovery, however, showed no positive trends. Transient Occupancy Tax proceeds, for example, were down for a third straight year last year, and the travel industry, after showing some potential earlier in the year, ended the year with Airport and hotel activity showing no signs of a recovery at all.

In the General Fund, we ended the year as well as we did due to a combination of aggressive cost containment strategies, actual mid-year budget reductions, and accurate revenue estimating. On the cost side of the equation, aggressive measures were imposed all during the year. The hiring freeze (first imposed in 2001) was continued throughout the 2003-2004 fiscal year, departmental Cost/Position Management plans were required from all departments for a third year in a row, resulting in mid-year budget reductions totaling \$8.6 million in the General Fund. These savings were placed in reserve and used to help balance the 2004-2005 General Fund budget. Additional controls were also continued on a number of additional non-essential expenditure categories, including those related to overtime, travel, marketing, and technology purchases. In addition, as a result of City Council approval of the Mayor's February Mid-Year Budget Actions Memorandum, the Administration presented a General Fund 100 Vacant Positions Elimination Plan, which was subsequently approved by City Council in March 2004. Savings from that action were also instrumental in helping balance the 2004-2005 budget. Finally, in April 2004, the City Council approved a proposal to accelerate 2004-2005 Proposed Operating Budget proposals for implementation in 2003-2004 rather than waiting for July 1, following direction that was also included as part of the Mayor's February Mid-Year Budget Actions Memorandum, approved by City Council last February.

On the revenue side of the General Fund, receipts were closely monitored and reported to the City Council through the Monthly Financial Reporting process, and recommendations to adjust estimates downward were brought to the City Council as soon as it appeared necessary.

As a result of the active management of our revenue estimates, the General Fund in 2003-2004 we ended the year virtually right on the projected total, finishing within less than 0.02% (\$112,000) of the budgeted estimate, a remarkable accomplishment given the total size of General Fund revenues (over \$648 million). The result of these strategies was a General Fund that ended the year in a positive position, with a fund balance surplus (from the budget) of \$23.3 million, the components of which are explained in greater detail later in this transmittal.

In summary, therefore, in 2003-2004, our policy choices and management strategies implemented to preserve the fiscal soundness of the City in the face of the very tough fiscal climate were successful, and of that we can be proud. Our forecasts unfortunately indicate that we will need to continue those efforts, as we believe additional tough times lay ahead. Accordingly, and in keeping with City Council policy, contained in this report is a recommendation to use all the remaining surplus General Fund fund balance monies left after rebudgeting and recommended clean-up actions (\$7.3 million) to establish a 2005-2006 Future Deficit Reserve.

## 2003-2004 GENERAL FUND PERFORMANCE OVERVIEW

As discussed above, the analysis of final 2003-2004 year-end financial data indicates that the City ended the year close to what was projected and within budget. Even with mid-year actions that removed savings from departments, which resulted from the Cost/Position Management Plans, cumulative departmental expenditures still ended the year below the budgeted level (1.3% or \$7.3 million). Much of these savings can be attributed to the general freeze on expenditures related to travel, overtime, technology purchases, etc, as well as the continuation of the City-wide hiring freeze. As a result of this performance, the 2003-2004 General Fund Ending Fund Balance of \$153.4 million was approximately \$23.3 million above the Fund Balance level estimate approved as part of the 2004-2005 Adopted Budget.

Table 1 (below) describes the three principal components of the \$23.3 million fund balance surplus. The surplus amount was composed of \$525,000 in higher than anticipated liquidation of carryover encumbrances, a \$975,000 shortfall in revenue collections (from the estimate used for fund balance projection purposes), and \$23.8 million in additional expenditures/transfers savings. A portion of these savings are recommended to be reinvested as a part of this report: \$6.9 million to be rebudgeted to complete various projects, and/or clean-up problems discovered since the approval of the 2004-2005 budget; \$2.7 million in Development Program fee proceeds which need to be placed in the existing Fee Program reserves as a result of the year-end reconciliation process comparing revenues and expenditures; and \$6.4 million for required adjustments discussed in greater detail later in this transmittal.

**Table 1**  
**Results of Operations in the General Fund**  
**For the Year Ended June 30, 2004**  
**(\$000's)**

<i>Sources</i>	<b>1</b> <b>Revised</b> <b>Budget</b>	<b>2</b> <b>Year-end</b> <b>Estimate</b>	<b>3</b> <b>Budgetary</b> <b>Basis</b> <b>Actual</b>	<b>4</b> <b>Variance</b> <b>1 to 3</b>	<b>5</b> <b>Variance</b> <b>2 to 3</b>
<i>Beginning</i>					
<i>Fund Balance</i>	183,372	183,372	183,372	-	-
<i>Liquidation of Carry-</i>					
<i>over Encumbrances</i>	671	1,871	2,396	1,725	525
<i>Revenue</i>	648,750	649,837	648,862	112	(975)
<i>Totals</i>	832,793	835,080	834,630	1,837	(450)
<i>Uses</i>					
<i>Expenditures</i>	725,375	698,642	674,617	50,758	24,025
<i>Transfers</i>	6,639	6,639	6,559	80	80
<i>Reserves</i>	100,779	(305)	-	100,779	(305)
<i>Totals</i>	832,793	704,976	681,176	151,617	23,800
<i>Available Ending</i>					
<i>Fund Balance</i>	N/A	130,104	153,454	153,454	23,350

## 2003-2004 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)

Table 2 below compares the City's financial performance in 2003-2004, with the financial performance of the prior year (2002-2003).

**Table 2**  
**General Fund**  
**Comparison of Year-End Actuals With Prior Year**  
**(\$ in millions)**

<i>Sources</i>	<b>2002-2003</b>	<b>2003-2004</b>	<b>Change</b>	<b>% Change</b>
<i>Beginning Fund Balance</i>	236.1	185.8	(50.3)	(21.3%)
<i>Revenue</i>	643.5	648.8	5.3	0.8%
<i>Total Source</i>	<u>879.6</u>	<u>834.6</u>	<u>(45.0)</u>	(5.1%)
<i>Uses</i>				
<i>Expenditures</i>	713.3	674.6	(38.7)	(5.4%)
<i>Transfers</i>	6.7	6.6	(0.1)	(1.5%)
<i>Total Use</i>	<u>720.0</u>	<u>681.2</u>	<u>(38.8)</u>	(5.4%)
<i>Available Ending Fund Balance</i>	<u>159.6</u>	<u>153.4</u>	<u>(6.2)</u>	(3.9%)

As shown in Table 2, 2003-2004 General Fund revenues of \$648.8 million represented an increase (0.8% or \$5.3 million) from the prior year's collection level. The slight increase from the prior year reflected the combined performance of General Fund Revenue categories. Decreases from the prior year level were experienced in a number of sources: Transient Occupancy Tax, down 1.5%; Franchise Fees, down 1.2%; Use of Money and Property, down 30.6%; Revenue from Local Agencies, down 2.7%; Revenue from the State of California, down 23.8%; and Transfers and Reimbursements, down 1.9%. These declines were offset by higher receipts in the remaining revenue categories: Property Tax, up 2.2%; Sales Tax, up 2.5%; Utility Tax, up 4.1%; Licenses and Permits, up 13.3%; Fines, Forfeitures, and Penalties, up 13.5%; Revenue from the Federal Government, up 27.0%; Departmental Charges, up 19.7%; and Other Revenue, up 32.9%. The overall performance represents the first indication that the pace of the declines in revenue suffered by the City in the past three years has slowed, which barely prevented the City from experiencing a third consecutive year of actual declining General Fund revenue collections, a result which had not happened in decades. Although revenue collections increased when compared to last year, it is still prudent, however, to keep in mind that revenues remain almost 2% down from the peak level experienced just two years previous to the 2002-2003 fiscal year.

General Fund expenditures of \$681.2 million declined 5.4% (\$38.8 million) when compared to the prior year expenditure level of \$720.0 million, reflecting both the reductions in the budget approved for 2003-2004 and the savings achieved by the strong efforts adopted by the City to contain costs to the extent possible in the face of declining revenues.

### 2003-2004 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)

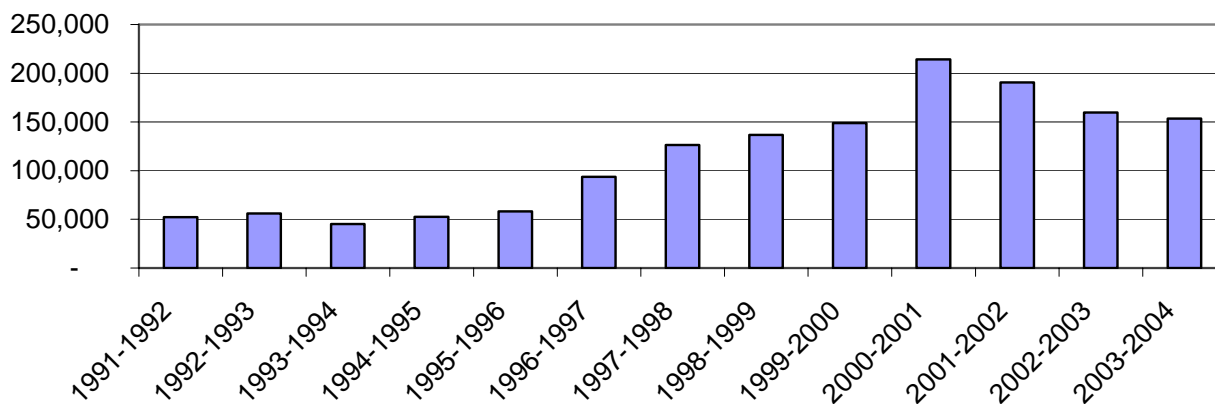
However, it is worth noting that even with an overall decrease in expenditure growth and a concerted effort to keep costs down, personal services expenditures still grew by almost 1% or \$3.2 million. As reflected in the following table (Table 3), all other expenditure categories experienced declines.

**Table 3**  
**General Fund**  
**Comparison of Year-End Actuals With Prior Year By Expenditure Category**  
**(\$000's)**

Category	2003-2004 Actual	2002-2003 Actual	Variance	% Variance
<i>Personal Services</i>	485,475	482,307	3,168	0.7%
<i>Non-Personal/Equipment/Other</i>	84,790	89,627	(4,837)	(5.4%)
<i>City-Wide Expenses</i>	86,528	97,932	(11,404)	(11.6%)
<i>Capital Contributions</i>	17,824	43,439	(25,615)	(59.0%)
<i>Transfers</i>	6,559	6,696	(137)	(2.0%)
<i>Reserves</i>	-	-	-	N/A
<b>TOTAL GENERAL FUND</b>	<b>681,176</b>	<b>720,001</b>	<b>(38,825)</b>	<b>(5.4%)</b>

Although the year ended with fund balance higher than budgeted, it should still be noted that in 2003-2004, the City, as planned, achieved a balanced budget in the General Fund in part by spending down a portion of its accumulated fund balance. As a result, compared to the Available Ending Fund Balance of 2002-2003 (\$159.6 million), the City's 2003-2004 year-end Available Ending Fund Balance (\$153.4 million) was down (by \$6.2 million). As seen in the chart below, this was the third year in a row that the City incurred a net annual decrease in the size of the General Fund's ending fund balance, after experiencing only one instance of a year to year decrease in the prior decade.

**General Fund**  
**Fund Balance History**



## **ANALYSIS OF 2003-2004 GENERAL FUND OPERATIONS**

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The following is a summary discussion by category of how the various components of the General Fund budget performed in 2003-2004. A more detailed explanation of the activities in each of these categories can be found later in this document.

### **Sources of Funds**

Overall General Fund sources of funding (revenue plus fund balance) ended the year \$1.8 million (0.22%) above the 2003-2004 final Modified Budget level, and essentially flat when compared to the estimate used to develop the 2004-2005 Adopted Budget's beginning fund balance component.

Total General Fund revenue collections of \$648.8 million ended the year less than one percent (0.02% or \$112,000) above the 2003-2004 Modified Budget level. As described above, this performance was the cumulative result of a number of higher and lower than budgeted revenue source performances. A net adjustment of approximately \$2.7 million to Development Fee Program Reserves is recommended as part of this report to adjust the reserves to the amounts actually generated by various Fee Programs. Net of revenues and expenditures, an adjustment of \$2.0 million is recommended for placement in the Planning and Building Fee Program Reserves; \$590,000 is recommended for placement in the Public Works Fee Program Reserve; and \$157,000 in the Fire Fee Program Reserve. These actions are consistent with the budget policy enacted several years ago, preserving any expenditure savings or revenue excess in these fee programs in reserves dedicated to that purpose.

### **Uses of Funds**

Overall, General Fund uses of funds ended the year \$151.6 million under (down 18.2%) the 2003-2004 modified budget level, and \$23.8 million below (down 3.4%) the estimate used to formulate the 2004-2005 Adopted Budget's beginning fund balance component. Most of the savings total, approximately \$127.8 million, was previously estimated to be available by year-end as part of the beginning fund balance estimate that was included in the 2004-2005 Adopted Operating Budget. The net additional savings in this category was \$23.8 million.

The recommitment of funding through rebudgeting actions is recommended as part of this report to fund uncompleted projects and to allocate development-related expenditure savings to the appropriate development-related activities. A more detailed discussion of the significant specific rebudget amounts is provided in the *General Fund Expenditure Performance* section found later in this document. After accounting for these additional recommended rebudgets, including reserves, net savings of approximately \$7.3 million was realized, primarily from personal services, non-personal/equipment, and capital savings.

## **ANALYSIS OF 2003-2004 GENERAL FUND OPERATIONS (CONT'D.)**

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### **Uses of Funds (Cont'd.)**

The 2003-2004 General Fund Contingency Reserve ended the year at \$22.2 million. This was 6.4% below (down \$1.5 million) the 2002-2003 year-end level of \$23.7 million, but still met the Council policy goal of being at least 3.0% of total budgeted General Fund expenditures (excluding encumbrances, the Contingency Reserve, and the Workers' Compensation Reserve). At the beginning of each year, the Contingency Reserve is established at a level necessary to meet or exceed the City Council's reserve policy level of 3.0% of expenditures. During the year, however, the reserve level can sometimes drop below 3.0% if significant additions to the budget or uses of the Contingency Reserve are approved.

### **Ending Fund Balance**

The current budgeting practice of the City is to use the fund balance remaining in the General Fund at the end of any fiscal year, after the establishment of sufficient funding in the Contingency Reserve, as a funding source for the following year. Thus, each year during the budget process, a detailed estimate of the unused balance in the fund is incorporated into the Adopted Budget.

The Ending Fund Balance estimate always contains two components: the portion of the fund balance that needs to be rebudgeted for completing projects or retaining reserves; and that portion which is truly undesignated and available as a general funding source in the coming year. The undesignated portion is further divided into ongoing and one-time components to assure that the City does not fund ongoing programs with one-time fund balance monies. The components of ending fund balance in any year are unexpended reserves, expenditure/transfer savings, excess revenue, and liquidated encumbrances.

When the 2004-2005 Operating Budget was developed, it was assumed that the 2003-2004 ending fund balance would total approximately \$130.1 million. As discussed earlier, the actual ending fund balance of \$153.4 million was \$23.3 million above the budgeted level, but \$6.2 million below the prior year level. This use of fund balance accumulated over several years is both a reminder of the very different and difficult financial environment the City is now operating in, and an indication of how important it is for us to adopt the type of cautious financial strategy recommended in this report concerning the commitment of any additional one-time funding that becomes available.

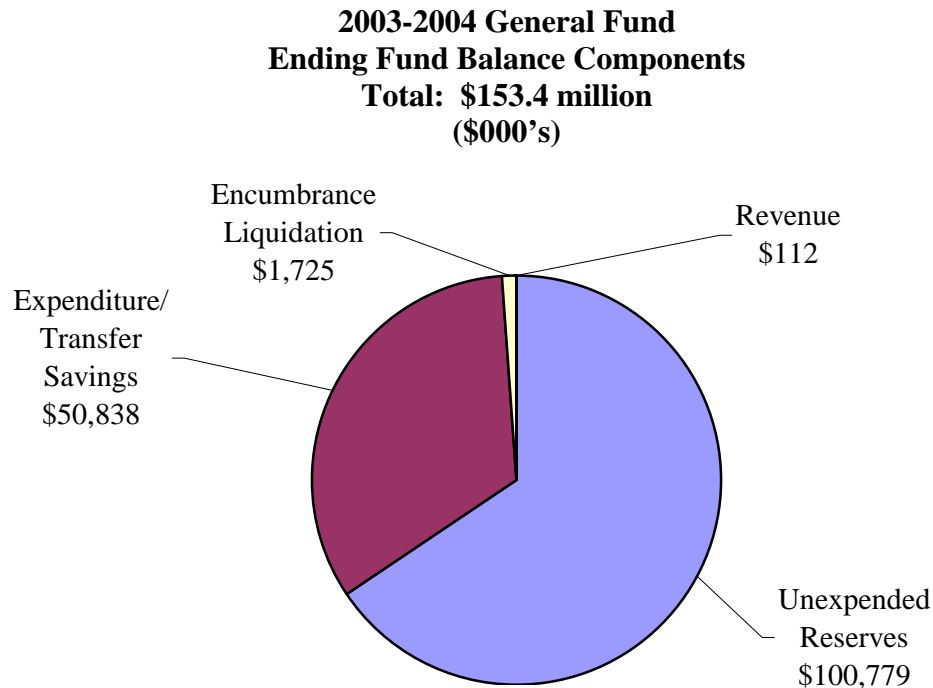
The components of the 2003-2004 General Fund Ending Fund Balance are described below:



## ANALYSIS OF 2003-2004 GENERAL FUND OPERATIONS (CONT'D.)

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### Ending Fund Balance (Cont'd.)



- The largest component of the Ending Balance, unexpended reserves, totaled \$100.8 million, which represents contingency reserve (\$22.2 million) and earmarked reserves (\$78.6 million). The most significant components of the earmarked reserves were the following: Reserve for Uneconomic Uncertainty (\$15.8 million); Workers' Compensation Reserve (\$10.0 million); 2004-2005 Future Deficit Reserve (\$16.5 million); Salaries and Benefits Reserve (\$12.9 million); Future Capital Projects (FF&E) Reserve (\$6.8 million); and Development-Related Activities Reserves (\$3.5 million).
- Expenditure/Transfer savings totaled \$50.8 million. A large portion of these savings (\$26.7 million), were rebudgeted as part of the 2004-2005 Adopted Budget for completion of 2003-2004 programs. Additional expenditure/transfer rebudgets and technical adjustments totaling \$9.6 million are recommended as part of this report.
- The total excess sources of funding (revenue plus fund balance) were \$112,000. This remainder reflects additional revenue received beyond the budgeted estimate.

## ANALYSIS OF 2003-2004 GENERAL FUND OPERATIONS (CONT'D.)

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### Ending Fund Balance (Cont'd.)

- The final component of the Ending Fund Balance is the value of the liquidation of carryover encumbrances, which in 2003-2004 totaled \$2.4 million. Actual liquidations ended the year above the \$1.9 million level assumed in the 2004-2005 Adopted Budget.

## IMPACTS ON THE 2004-2005 ADOPTED BUDGET

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### Beginning Fund Balance

With the City's current budget practice, ending fund balance amounts carried into the next fiscal year as beginning fund balance is a significant source of one-time funding for the budget. As described previously, the actual General Fund ending balance was above the estimate used in the 2004-2005 Adopted Budget by \$23.3 million. Including Earmarked Reserves, a total of \$16.0 million of this amount is recommended to be rebudgeted and/or utilized to correct problems discovered with the Adopted Budget (described in more detail below). Per City Council policy, the remaining \$7.3 million is recommended to be allocated to a 2005-2006 Future Deficit Reserve. Coincidentally, this is almost exactly the same amount placed in reserve from prior year monies as part of last year's Annual Report.

The following chart details the recommendation for use of the \$23.3 million additional fund balance:

### PROPOSED ALLOCATION OF ADDITIONAL FUND BALANCE (\$000s)

<b>Fund Balance Variance</b>	<b>\$ 23,350</b>
Changes to Fee Reserves	2,700
Rebudgets/Technical Adjustments	6,926
Required/Recommended Current Year Adjustments	6,393
2005-2006 Future Deficit Reserve	7,331
<b>Fund Balance After Recommended Adjustments</b>	<b>\$ 0</b>

- **Changes to Fee Reserves (\$2.7 million)** – Consistent with the budget policy enacted several years ago, a net \$2.7 million is recommended to be added to the Development Program Fee Reserves (Building, Planning, Fire, and Public Works), preserving all expenditure savings and/or revenue excess in these programs. In addition, adjustments are proposed to the development fee programs to meet development service performance targets and customer service needs in 2004-2005. These recommended adjustments include two Associate Engineer positions and related non-personal/equipment, and a reorganization of the building inspection management function in the Building Fee Program (\$261,000) and imaging assistance for remaining records for the Planning (\$100,000) and Public Works (\$100,000) Fee Programs. All of these additions will be offset by corresponding reductions to the existing earmarked reserves for development-related activities.

## IMPACTS ON THE 2004-2005 ADOPTED BUDGET (CONT'D.)

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### Beginning Fund Balance (Cont'd)

- **Rebudgets/Technical Adjustments (\$6.9 million)** – These adjustments are recommended to complete existing projects in 2004-2005 and to reflect any necessary technical budget adjustments. The Annual Report is the point in the budget process where action is required to provide for the rebudgeting of year-end savings not anticipated when the Adopted Budget was approved, but required to complete a significant City Council approved project. Also recommended are actions that actually reduce previous rebudgets in various departments Capital and the City-Wide Expenses category to reflect instances where greater than expected expenditures occurred in 2003-2004 and those funds are, therefore, not needed in the current year. A net total of \$6.9 million of Rebudgets/Technical Adjustments are identified in this report that need to be carried to the 2004-2005 fiscal year in order to complete the specific projects and programs. The two largest components of this rebudget/technical adjustment recommendation are General Fund Capital Projects (\$1.5 million) and City-Wide Expenses (\$5.4 million).
- **Required/Recommended Current Year Adjustments (\$6.4 million)** – Several budget additions and reductions are recommended to address a number of current year funding changes that have emerged since the budget was approved. The following augmentations are recommended: a transfer of excess Construction and Conveyance Tax revenue to the Park Maintenance Reserve (\$2.2 million) as required by current Council policy; rebudgeting of Senior Staff Home Loan repayments (\$1.5 million); the provision of funding for a loan to the Community Facilities Revenue Fund to ensure debt service coverage for the Hayes Mansion (\$1.0 million); the provision of additional General Fund funds to the Convention and Cultural Affairs Fund to resolve negative fund balance issues (\$975,000); additional subsidy funding for the Municipal Golf Course Fund to fill the expected gap between golf course earnings and debt service requirements (\$300,000); the provision of funds for potential litigation around the Cable Franchise renewal process (\$200,000); funding for the coming City Hall investigation (\$60,000); additional funding to provide additional resources to strengthen the City's Purchasing operation (\$50,000); funding to establish a fund for Mayor and City Council travel for official representation duties (\$35,000); funding to provide a technical correction for New City Hall utility and other initial moving costs (\$48,000); funding for the search process for a new Independent Police Auditor (\$23,000); and a small technical correction for the Camden debt service payment budget (\$2,000). These items are described in much more detail elsewhere in this document.
- **2005-2006 Future Deficit Reserve (\$7.3 million)** – After the above actions, per City Council policy, the remaining \$7.3 million in unallocated funds is recommended to be used to establish a 2005-2006 Future Deficit Reserve. Doing so would help prepare the organization to address what will surely prove to be a challenging, upcoming budget year. The recommended reserve is consistent with the fiscally cautious approach that has served the City so well up to this point.

## IMPACTS ON THE 2004-2005 ADOPTED BUDGET (CONT'D.)

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### Additional Adjustments to the 2004-2005 Adopted Budget

In addition to the previously discussed recommended uses for the surplus fund balance, a number of other revenue-related adjustments and reallocations are proposed as a part of this report.

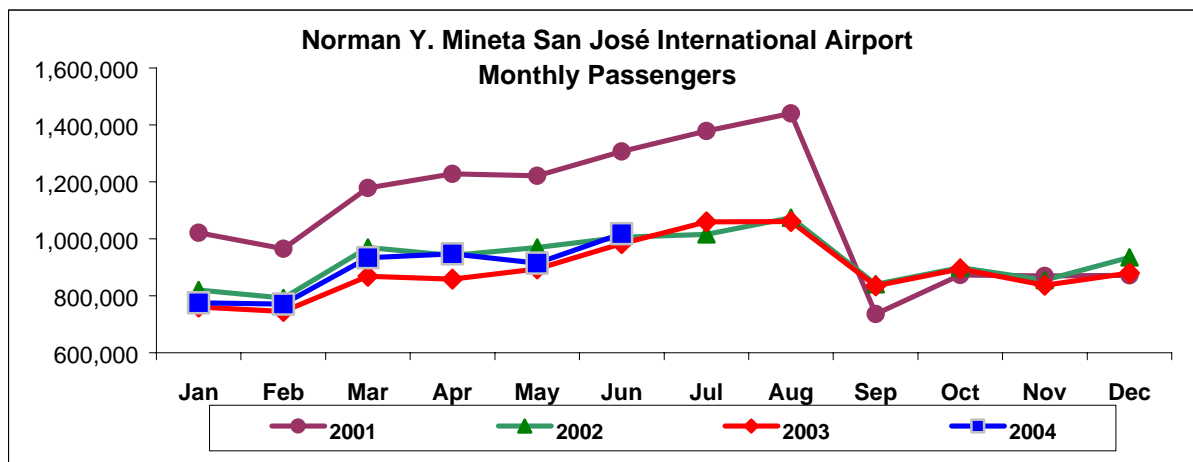
- **Revenue-Related (\$501,000)** – Generally, this category of adjustments rebudget the revenue and corresponding expenditure budget for various grants to 2004-2005, including the following: Evergreen Smart Growth (\$76,000); DUI Enforcement Campaign (\$13,000); Childcare Tax Credit (\$39,000); Internet Crimes Against Children (\$201,000); California 21st Century Community Learning Centers (\$759,000) Metropolitan Medical Strike Team (down \$495,000); Seat Belt Compliance (down \$29,000); Washington Weed & Seed Program (down \$41,000); and Coyote Valley Specific Plan (down \$22,000).
- **Reallocations** – This category of recommended actions redistributes funds to reflect the appropriate placement of funding for approved budget actions. The largest portion of funding movement that falls into this category was that necessary to reflect the Council-approved elimination of management salary increases and the suspension of the Professional Development Program (\$1.2 million). For administrative ease, these reductions were reflected in the Salary and Benefit Reserve in the 2004-2005 Adopted Operating Budget. That holding action must now be replaced by reductions to each department budget. In addition, as directed in the Mayor's June Budget Message, the new Strong Neighborhoods Initiative (SNI) model was revisited and further consideration was given for the diversity among the various SNIs. This review has resulted in a reallocation of personal and non-personal/equipment funds dedicated to SNI and the Neighborhood Development Center in PRNS to be used to augment staffing resources for SNI to ensure seamless delivery of services. As a result, four net positions are recommended as part of this report and the program is being transferred from PRNS to the City Manager' Office. Finally, in order to correctly allocate maintenance funds for the Delmas/VTA Dog Park a transfer of \$3,900 from Transportation Department to Parks, Recreation and Neighborhood Services Parks Maintenance is necessary and also recommended in this report.

## STATUS OF SPECIAL/CAPITAL FUNDS

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### Airport Operating Funds

Airport passenger activity increased only slightly (1.9%, 199,146 passengers) during 2003-2004 compared to the prior year, but does reflect the first fiscal-year increase, however small, to occur since the September 11 terrorist attacks. In June, the City welcomed JetBlue to San José, introducing a new passenger air carrier to the Airport, as well as a daily non-stop flight to New York's John F. Kennedy Airport. The introduction of a new carrier and the annual increase in passenger activity shows stability in activity, however, the increase does not indicate a sustained recovery or a return to the growth rates experienced prior to September 11. While the total number of passengers increased, the number of operations among large commercial passenger carriers actually decreased by approximately 5,000 flights, a decrease of 9.2% for the year. San José air carriers did increase the number of regional jets serving San José in order to provide the most cost efficient service to destinations to and from San José. Regional jet use increased by 62.0% during the year, however, since these aircraft have lower landed weights they generate less revenue.



Overall, Airport operating revenues met budgeted estimates, with Terminal Rentals, Parking and Roadway and General and Non-Aviation revenues exceeding estimates and Landing Fees and Concessions revenues falling slightly under budget. In order to meet the challenge posed by limited revenues and the need to maintain customer service levels, the Airport continued its practice of setting service priorities, savings targets and closely monitoring all expenditures. The Airport department set a target to save a total of \$4.9 million in direct personal services and non-personal/equipment expenses during 2003-2004. By the end of the fiscal year, the savings target was met and exceeded by over \$3 million. In addition conservative management of reserves provided an additional \$6 million in savings. These actions contributed to the higher than anticipated fund balances present in Airport funds at year-end.

## **STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)**

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### **Community Facilities Revenue Fund**

Effective January 1, 2004, Dolce International/San Jose, Inc. (Dolce) was appointed Manager of the Hayes Mansion facility under the terms of a ten-year (with options to extend) management agreement with the City. As part of the agreement, Dolce transfers the necessary money from Hayes Mansion operations to this fund for debt service and to reimburse the City for some operating costs, such as insurance. Initial projections of operating results for 2004-2005 had assumed that revenues plus draws from a line of credit with Comerica Bank would be sufficient to cover expenses for the Hayes Mansion, including debt service on the Hayes Mansion bonds. It is now assumed that although there will be some improvement in revenues in 2004-2005, compared to 2003-2004, collections will not be at a level sufficient to cover operating expenses plus debt service on the Hayes Mansion bonds. A \$1.0 million transfer and loan from the General Fund is recommended as part of this report to assist in the payment of debt service for the facility.

### **Convention and Cultural Affairs Fund**

The Convention and Cultural Affairs Fund ended the year well below expected levels due to lower than anticipated revenue collections during the last two months of the year. Revenue collections were \$2.6 million below the modified revenue estimate. This was mainly due to lower than expected space rental and concessionary income for the year as well as lower than expected transfers from the Parking Fund (\$139,000) due to decreased activity levels. The overall occupancy rate for the Convention Center was approximately 70% for 2003-2004, which is down significantly from the 80% that was realized in 2002-2003, and well below budgeted expectations. Expenditure savings of \$344,000 reflect savings in a number of categories including personal services expenses (\$26,000), and non-personal/equipment expenses (\$280,000). The shortfall in revenue results in the unrestricted ending fund balance of this fund ending the year in a negative position. In order to correct the negative fund balance (\$875,000) in this fund, a transfer of \$975,000 from the General Fund to the Convention and Cultural Affairs Fund is recommended as part of this report in order to address this shortfall and provide a minimum fund balance level to start the year.

### **Low and Moderate Income Housing Fund**

Revenues and expenditures in the Low and Moderate Income Housing Fund ended the year significantly below budgeted levels (\$80 million each). In 2003-2004, revenues were reduced at mid-year to reflect the impact of reduced property taxes upon the 20% Tax Increment. In addition, at the time, budget proposals were being considered by the State that could seriously affect Redevelopment Agency funding for affordable housing in 2004-2005. As a result, the Housing Department strategically reduced borrowing in 2003-2004 through the use of Tax Allocation Bonds until reliable projections of future revenue became available.

Subsequent to the adoption of the 2004-2005 budget, the Redevelopment Agency received its property tax information from the Santa Clara County Tax Assessor. The impact upon the 20% Tax Increment transfer from the Redevelopment Agency to this fund is a reduction of \$4.0 million. A recommendation to recognize this reduction is included in this document. As this had been anticipated, there should be no significant impact to currently planned projects.

## **STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)**

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### **Municipal Golf Course Fund**

Los Lagos and Rancho del Pueblo Golf Courses 2003-2004 revenues ended the year well below (38.0%) budgeted levels. The 2004-2005 Adopted Budget estimates for this fund assumed that revenues would perform at the 2003-2004 estimated level. It is now anticipated that revenues in this fund will continue to perform at this reduced level and a transfer from the General Fund is necessary to pay for debt service for these two golf courses in 2004-2005 and beyond. For 2004-2005, the amount recommended in this report to be transferred from the General Fund is \$300,000.

### **Transient Occupancy Tax Fund**

Collections for the Transient Occupancy Tax (TOT) in 2003-2004 continued the downward trend of the prior two years. Collection fell below the modified budget amount (which had been revised downward during the year twice) by \$133,000. The average hotel occupancy rate declined for a third straight year, from 54.4% to 48.8%; and the average room rate also continued its fall, from \$117.20 to \$110.69. Unfortunately, this trend seems to be continuing into 2004-2005. For the first months of 2004-2005, the average occupancy rate has been relatively steady at 50.2%, but the room rate has fallen even further to \$109.80.

TOT Fund tax revenue is, by ordinance, shared by three groups: the Convention Center Operation Subsidy (50%), the Convention Visitors Bureau (25%), and Cultural Grants (25%). Since tax receipts for 2003-2004 ended the year below anticipated levels, this report contains actions required to recoup overpayments made last year. The following reductions would be made to the three groups: \$67,000 to the Convention Center Operation Subsidy, \$33,000 to the Convention Visitors Bureau, and \$33,000 to Cultural Grants. These reductions are in addition to reductions to funding to these groups performed twice before during the year.

### **Capital Improvement Program Funds**

In 2003-2004, collections in several of the major capital tax revenue categories significantly exceeded the estimates included in the modified budget. The Construction and Conveyance Taxes also tracked well above the prior year collection levels, while the Construction Excise and Building and Structure Construction Taxes that primarily support the Traffic Capital Program fell below the 2002-2003 levels.

Year-end collections in the **Building and Structure Construction Tax** category totaled \$9.0 million, which was \$1.7 million above the modified budget estimate of \$7.3 million, but was \$1.8 million (16.4%) below the \$10.8 million received in 2002-2003. With a similar trend, Construction Excise Tax receipts of \$14.0 million exceeded the modified budget estimate of \$12.1 million by \$1.9 million but were \$3.0 million (17.6%) below the 2002-2003 collection level of \$16.95 million.

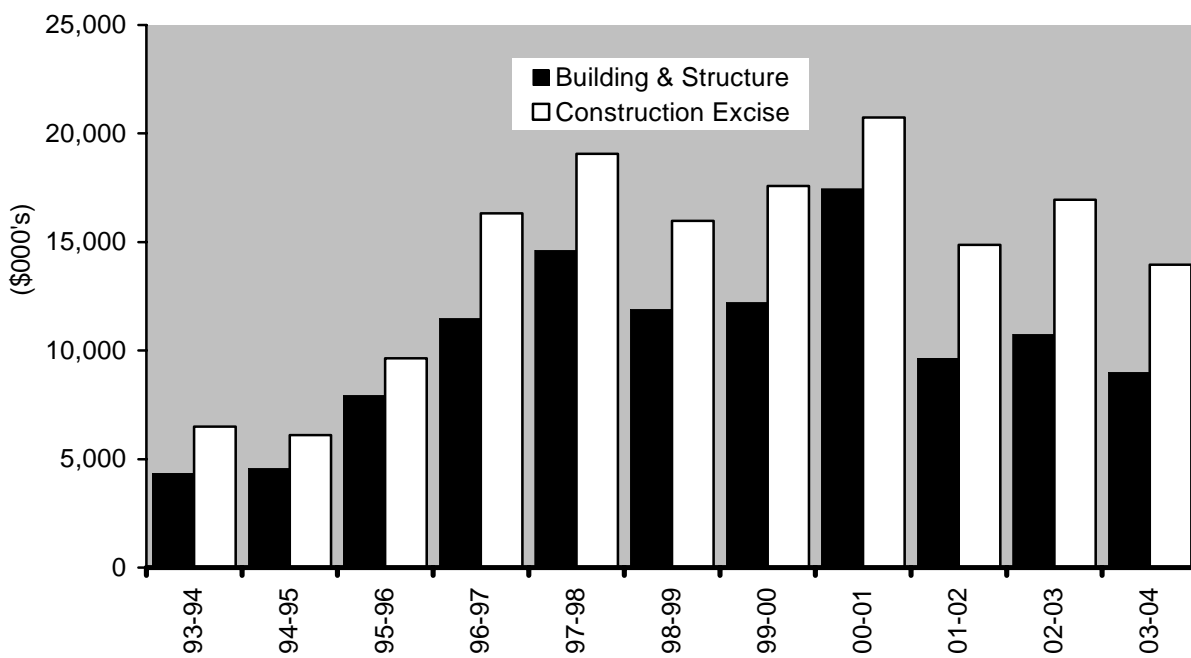
## STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

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### Capital Improvement Program Funds (Cont'd.)

The following graph displays the collection history of both the Building and Structure and Construction Excise Tax receipts over the past eleven years and illustrates the dramatic growth during the latter part of the 1990's. While collections have fallen from the peak in 2000-2001, they have remained relatively strong when considering the historical performance of these taxes.

**Construction Tax Revenues**



**Construction and Conveyance Tax** revenues, which are a significant source of funds for the Park and Community Facilities Development, Library and Fire capital programs, experienced phenomenal growth of 53.5% in 2003-2004. Actual receipts totaled \$38.1 million, significantly exceeding both the budgeted estimate of \$24 million and the 2002-2003 collection level of \$24.8 million. This historically high collection level was realized after two years of declines in this revenue category. When the 2003-2004 budget was developed, it was assumed that receipts would continue to decline based on the sluggish state of the economy and the potential rise in interest rates. This, however, obviously did not occur as the number of housing sales increased dramatically and the home prices also experienced growth. The number of real estate sales in San José instead increased 41.4% from the prior year, and the single-family median home price as of June 2004 of \$585,000 was 14.5% higher than the June 2003 figure of \$511,000.



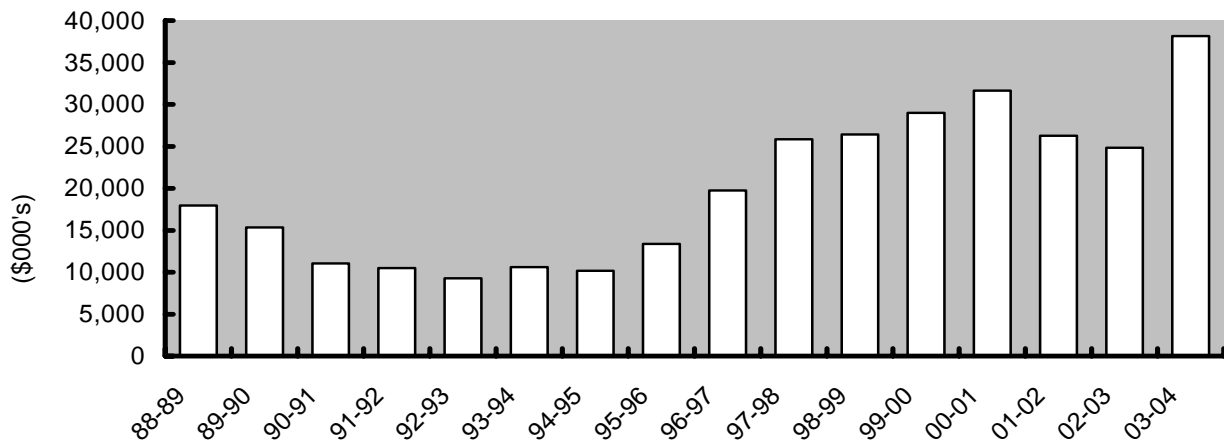
## STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

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### Capital Improvement Program Funds (Cont'd.)

The following graph displays the collection history of Construction and Conveyance Tax receipts. As can be seen, during the recession years in the early 1990s collections hovered around the \$9-11 million level for approximately five years. Following that recession, collections surged, with receipts reaching \$31.6 million in 2000-2001. After reaching this peak, collections dropped in both 2001-2002 and 2002-2003. The unprecedented growth of over 50% in 2003-2004 ended this downward trend that was expected to continue until the economy recovered. With the baffling level of growth that occurred in 2003-2004 exceeding our expectations by a wide margin, particularly given the economic health of the region, it is very difficult to predict the level of activity in 2004-2005. There is some risk that the housing market has entered a phase of unsustainable growth, similar to the stock market bubble experienced earlier this decade. If this is the case, there may be some market corrections that would impact this category. The 2004-2005 Adopted Budget estimate of \$18.0 million, now looks extremely conservative and obviously allows for a significant decline in this category. Based on the collection levels in recent years, it is anticipated that this revenue category can likely be adjusted upwards during the year.

**Construction and Conveyance Tax Revenues**



## LOOKING AHEAD

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Although the weak local economy continued to negatively impact the City throughout the 2003-2004 fiscal year, we successfully managed the resulting budgetary challenges, ending the year in a sound financial position.

**LOOKING AHEAD (CONT'D.)**

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The City organization can be proud that it has been able, for the most part, to maintain essential City services and programs in the face of ever shrinking resources. Unfortunately, the indications are both nationally and locally that we will continue to experience a weak economy for the foreseeable future.

Once again it is also worth reiterating our belief that the most crucial indicator of local economic health is and will continue to be the employment situation in the County, and although there are a few signs of slight improvement in this sector as well, one reason we remain very cautious about our short term fiscal outlook is the generally sluggish employment situation which continues to plague our regional economy.

It is a testament to the Mayor and City Council's leadership and steadfast commitment to sound fiscal planning that the City remains in a strong and relatively enviable financial position. I am very confident that it will be this same leadership, along with the combined dedication of policymakers and administration alike that will help this City manage successfully through whatever difficult times that lie ahead.

As always, the Administration will continue to monitor the current year closely, reporting the City's fiscal status to the City Council through the Monthly Financial Report and Mid-Year Budget Review process.

DEL D. BORGS DORF  
City Manager

## HONORABLE MAYOR AND CITY COUNCIL

September 30, 2004

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I hereby certify that there will be available for appropriation in the designated funds and in the amounts as listed below in fiscal year 2004-2005 monies in excess of those heretofore appropriated therefrom:

General Fund	\$	24,431,519
Airport Capital Improvement		4,610,182
Airport Maintenance and Operations		3,488,725
Airport Passenger Facility Charge		5,861,138
Airport Renew & Replacement		3,570,154
Airport Revenue		10,339,888
Airport Surplus Revenue		6,112,712
Anti-Tobacco Master Settlement Agreement		825,308
Building & Structures Construction Tax		7,976,058
Branch Library Bond Project		1,910,735
Business Improvement District		122,440
City Hall Renovation Construction		1,129
Civic Center Construction		3,919,547
Civic Center Improvement		19,690,000
Civic Center Parking		449,251
Community Development Block Grant		3,445,019
Community Facilities District 1		47,454
Community Facilities District 2 and District 3		19,559
Community Facilities Revenue		1,000,000
Consolidated Water Utility		20,920
Construction & Conveyance Tax - Council District 1		866,157
Construction & Conveyance Tax - Council District 2		342,389
Construction & Conveyance Tax - Council District 3		372,637
Construction & Conveyance Tax - Council District 4		690,632
Construction & Conveyance Tax - Council District 5		1,291,346
Construction & Conveyance Tax - Council District 6		802,863
Construction & Conveyance Tax - Council District 7		808,793
Construction & Conveyance Tax - Council District 8		383,033
Construction & Conveyance Tax - Council District 9		551,545
Construction & Conveyance Tax - Council District 10		764,796
Construction & Conveyance Tax - Central Fund		1,223,021
Construction & Conveyance Tax - City-Wide		1,708,191
Construction & Conveyance Tax - Communications		711,710
Construction & Conveyance Tax - Fire		1,604,787
Construction & Conveyance Tax - Library		3,177,261
Construction & Conveyance Tax - Parks Maintenance		143,423
Construction & Conveyance Tax - Service Yards		1,429,379
Construction Excise Tax		9,459,350
Customer Facilities & Transportation		143,512
Development Enhancement		271,069
Federal Drug Forfeiture		3,747
General Purpose Parking		1,118,615
Gift Trust		135,583
Home Investment Partnership		4,406,406
Housing Trust		555,412
Integrated Waste Management		5,124,551

Interim City Facility Improvements	\$	1,600,000
Lake Cunningham		103,683
Library Benefit Assessment District		934,457
Low & Moderate Income Housing		648,311
Maintenance Assessment District 1		165,750
Maintenance Assessment District 5		9,433
Maintenance Assessment District 8		14,396
Maintenance Assessment District 11		8,073
Maintenance Assessment District 13		11,268
Maintenance Assessment District 15		170,910
Maintenance Assessment District 18		8,377
Maintenance Assessment District 20		12,759
Maintenance Assessment District 21		29,746
Maintenance Assessment District 22		27,255
Multi Source Housing		740,673
Municipal Health Services Program		77,030
Neighborhood Security Bond		5,693,056
Park Trust		6,282,939
Parks & Recreation Bond Project		1,078,937
Residential Construction Tax Contribution		333,604
Sewer Service & Use Charge		1,304,179
Sewer Service & Use Charge Capital		9,552,851
SJ-SC Treatment Plant Income		21,164
State Drug Forfeiture		241,539
Stores		225,395
Storm Drainage Fee		372,576
Storm Sewer Capital		695,690
Storm Sewer Operating		1,619,619
Supplemental Law Enforcement Services		191,297
Unemployment Insurance		145,703
Water Utility Capital		405,974

Larry D. Lisenbee  
Budget Director